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SOP 82-1: New Standards for Personal Financial Statements

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In June 1968, the Committee on Personal Financial Statements of the American Institute of Certified Public Accountants (AICPA) issued Industry Audit Gude, "Audits of Personal Financial Statements".[1] This guide represented the first authoritative document providing direction to independent auditors when examining and reporting on the financial affairs of individuals or groups of related individuals. The major consideration of this pronouncement was the requirement that personal financial statements be prepared in conformity with generally accepted accounting principles (GAAP) applicable to commercial enterprises. The purpose was to achieve uniformity and provide users with meaningful information.

Since the publication of the Audit Guide, the use and importance of personal financial statements has increased substantially. Consequently, in 1981 the Accounting Standards Executive Committee of the AICPA began a project to reevaluate accounting and reporting standards for personal financial statements. The ultimate objective of the project was to issue a revised audit guide relating to compilation, review, and audits of personal financial statements. As an interim step, in October 1981, the Committee released for public comment a draft revision of the accounting section of the 1968 Audit Guide.[2] The proposed revisions were made in light of the purpose for which personal financial statements are prepared, potential users and user groups, and the various ways the statements may be utilized. After considerable deliberation, in October 1982, the AICPA issued Statement of Position (SOP) 82-1, "Accounting and Reporting for Personal Financial Statements".[3] The SOP amends the accounting provisions of the Audit Guide and requires major changes in accounting and reporting standards for personal financial statements dated June 30, 1983, or thereafter.

Although Statements of Position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics, Statement of Auditing Standards (SAS) 5, as amended by SAS 43, indicates that these documents represent another major source of established accounting principles the auditor should consider. Accordingly, any departures from recommendations contained in SOPs must be justifiable by the auditor. Recognizing the significant impact a Statement of Position can have on the audit function, this article summarizes the content of SOP 82-1 and discusses the required changes in accounting and reporting standards for personal financial statements. The required financial statements and their basis of presentation are first reviewed, followed by a discussion of the recommended methods of valuing financial statement elements. To enhance the discussion, an overview is presented of the recommended methods for valuing selected personal assets (Exhibit 2) and for estimating current amounts of liabilities (Exhibit 3).

Basic Financial Statements

SOP 82-1 indicates that personal financial statements should provide adequate disclosure of relevant information relating to the financial affairs of an individual reporting entity. A reporting entity is identified as consisting of a single individual, a husband and wife, or a larger family group. For each reporting entity, the SOP requires the presentation of a Statement of Financial Condition as the primary financial statement. Although the general format of this statement is similar to the traditional Balance Sheet, the content and basis of presentation has been substantially changed. The Statement of Financial Condition for individuals is now required to present estimated current values of assets, estimated current amounts of liabilities, a provision for estimated taxes, and net worth. Whenever a Statement of Financial Condition is issued, a comparison of currrent period amounts with one or more prior periods should be made. The Committee concluded that this method of presentation is more informative than single year disclosure because it provides a point of reference for the user.

The SOP does not require the presentation of a Statement of Changes in Net Worth, but indicates that this statement may accompany the Statement of Financial Condition, if desirable. Unlike the requirement set forth in the 1968 Audit Guide, presentation of a Statement of Changes in Net Worth is now optional when comparative financial statements are presented. If a Statement of Changes in Net Worth is presented, it should disclose all major sources of increases and decreases in the reporting entity's net worth. Exhibit 1 lists those items which may result in changes in net worth.

EXHIBIT 1
Items Which Change Personal Net Worth

Increase	Decrease
1. Income	1. Expenses
2. Increase in estimated current value of assets	2. Decreases in estimated current value of assets
3. Decrease in estimated current amount of liabilities	3. Increases in estimated current amount of liabilities
4. Decrease in provision for estimated income taxes	4. Increase in provision for income taxes

Basis of Financial Reporting

Personal assets and liabilities are the primary focus in the Statement of Financial Condition. The Audit Guide required these financial statement items to be presented based on historical cost. The Guide states, "to achieve a desirable degree of uniformity and provide meaningful information,...financial statements for individuals should be prepared on a cost basis, in conformity with generally accepted accounting principles."[4] After reevaluating the information needs of users of personal financial statements, the Executive Committee believed that historical cost, as the primary basis of financial statement presentation, was inadequate. For instance, to assess credit risk, potential lenders require information about the current value of collateral. Estimated current values are also required for estate, gift, and income tax planning. Moreover, candidates for public office are required to disclose current value information relating to their personal financial affairs. Thus, the Committee concluded that historical cost does not satisfy the informational needs of users of personal financial statements.

The Committee recognized that certain users of personal financial statements need and require current value information rather than historical cost. To meet this need, the SOP requires the Statement of Financial Condition to present assets at their estimated current values and liabilities at their estimated current amounts, as determined on the financial statement date. Also, estimated current values of assets and estimated amounts of liabilities are required to be presented in the order of their liquidity and maturity, without any current and noncurrent classification. Interestingly, the current/noncurrent designation was not recommended because the Committee believed that the liquidity of a reporting entity is more important to users of personal financial statements than the concept of working capital. Finally, it should be noted that although estimated current value is the primary basis of presentation, the SOP does not preclude the presentation of historical cost information on a supplemental basis.

Valuation of Personal Assets

A major contribution of the SOP is the guidance provided in valuing personal assets and estimating amounts of liabilities. In establishing guidelines for determining current values of personal assets, the Committee concluded that in some instances a single valuation method could be identified and recommended as generally accepted, while in other instances multiple valuation methods are appropriate. As a general guide, the SOP states that estimated current values of personal assets should be the amount required in an exchange between a willing buyer and seller, each of whom is well informed of the underlying facts.

The use of recent sales information relating to transactions involving similar assets in similar circumstances is perhaps the most satisfactory basis for determining estimated current values and should be used whenever practicable. When recent sales information is not available, other valuation methods should be followed. Possible alternative methods include, but are not limited to, liquidation values, capitalization of past or prospective earnings, appraisal value, historical cost adjusted for specific price changes, and discounted cash flows. Whenever the cost of obtaining current value information exceeds the benefits, the SOP recommends the use of professional judgement in the estimation process. Regardless of the method selected, the objective is to provide useful information. This is consistent with the objectives of external financial reporting as set forth in Statement of Financial Accounting Concepts No. 1.[5]

As shown in Exhibit 2, the current value of receivables should be the present value of estimated future cash inflows. The present value of receivables is a function of (1) the discount rate and (2) the waiting period for expected cash receipts. The SOP does not establish a specific discount rate, but states than an "appropriate" interest rate on the financial statement date should be used. The selection of an appropriate discount rate will require the auditor to use his professional judgement. When making this selection, the auditor should consider the stated interest rate, market rates for credit of equal risk, and the individual's cost of capital rate. Also, no distinction is made between short and long-term receivables. If the waiting period for cash receipts is short, the net realizable value of receivables would closely approximate their present value and could be used. If, however, the waiting period is longer than one year, the proper value of the receivable should be the present value of future expected cash receipts.

The recommended method for valuing marketable securities depends on how the securities are being traded. The SOP states that when marketable securities are traded on a securities exchange, their current value should be the closing price on the financial statement date (Exhibit 2). However, if such securities are not actively traded on that date, their current value should be estimated within the bid and asked prices. Conversely, in those instances where marketable securities are traded over-the-counter, the estimated current value should be the mean of

EXHIBIT 2
Methods for Estimating Current Value of Assets

Item Classification	Recommended Valuation Method(s)
1. Receivables	Present value of future cash collections
2. Marketable securities traded on security exchanges:	
(A) if traded on the financial statement date	Closing prices of the securities.
(B) if not traded on the financial statement date	Select a value within the range of bid and asked prices for the securities.
3. Marketable securities traded over the counter	Average value of the bid and asked prices.
4. Marketable equity securities held in large blocks	Recent sales price adjusted for market effect of block sale.
5. Options	Published prices or estimated value based on the value of the asset subject to option.
6. Investment in life insurance	Net cash value of the policy.
7. Investment in closely held businesses	Liquidation value, appraisals, reproduction value, or discounted cash flows.
8. Real estate investments	Appraisals, assessed value for property taxes, market price if available, or discounted cash flows.
9. Intangible assets	Discounted cash flows if the amounts and timing can be estimated, otherwise use cost.
10. Qualifying nonforfeitable rights	Discounted cash flows.

either: (1) bid prices from different sources, (2) bid and asked prices, or (3) broker-dealer quotations for the securities on the financial statement date (Exhibit 2). By using quoted market prices for valuing securities, the reliability of information is substantially enhanced since the data are easily verifiable.

The Committee recognized that the market value of large blocks of equity securities may not be the market price at which individual shares are traded. In addition, a block of equity securities that represents a controlling interest may be proportionately more valuable than smaller interests. As indicated in Exhibit 2, the SOP requires the current market price to be adjusted to consider the effects of large blocks of securities and/or the existence of a controlling interest. No specific guidance is provided by the SOP for making such adjustments. Consequently, the auditor will be required to rely on his professional judgment.

Investments by individuals in closely held businesses can be in the form of a sole proprietorship, general and unlimited partnerships, and corporations. The SOP requires that the net investment in such businesses be presented in personal financial statements at estimated current values on the financial statement date. Generally, there will not be an established market for determining the investment's estimated market value. Consequently, the valuation process becomes difficult and professional judgment should be exercised. It is recognized in the SOP that there is no generally accepted procedure for determining estimated current values for investments in closely held businesses, but several alternative methods are proposed which should prove useful. These methods include appraisals, present values of net future cash flows, liquidation values, reproduction value, and adjustments of book value for appraisals of specific assets (Exhibit 2). The auditor should be cautious, however, and remember that the valuation procedure selected must be justifiable in light of the underlying circumstances.

The SOP requires investments in real estate (including leaseholds) to be presented in personal financial statements at their estimated current values. To assist in the valuation process, certain types of information may be useful. The SOP suggests the following:

(1) Sales price of similar property.
(2) Present value of net cash flows.
(3) Appraisals from independent real estate agents.
(4) Financial appraisals.
(5) Assessed value for taxing purposes.

Whenever personal financial statements are to be prepared for individuals who have nonforfeitable rights to receive certain sums, caution should be exercised in estimating the asset's current value. The SOP states that such nonforfeitable rights should be based on their discounted amounts if all of the following characteristics are met: (1) the rights are fixed or determinable, (2) the rights are not subject to contingencies relating to the holder's life expectancy or the occurrence of some future event, and (3) the holder is not required to perform a future service. If these characteristics are not present, no asset exists. Examples of nonforfeitable rights are:

1. Guaranteed minimum pension rights.
2. Vested rights in pension or profit sharing plans.
3. Alimony payments if fixed for a definite future period.
4. Interests in annuities.
5. Interests in deferred compensation plans.

Estimating Personal Liabilities

The SOP requires liabilities to be presented in personal financial statements at their estimated current amounts. The SOP defines estimated current amounts for payables and other liabilities as the discounted amounts of future cash payments. If the liability is due within a short period of time, the amount of the discount is usually immaterial and the liability can be presented at its face value. If discounting is required, the discount rate should be the lower of the implicit interest rate or the current market rate of similar debt. Noncancellable commitments to pay future sums are to be presented at their discounted amounts (Exhibit 3). Such commitments should be recognized only if (1) the rights are fixed or determinable, (2) the rights are not subject to contingencies relating to others life expectancy or the occurrence of some future event, and (3) others are not required to perform a future service. Fixed amounts of alimony payable for a definite future period and charitable pledges are examples of noncancellable commitments.

Personal financial statements are also required to disclose a liability for income taxes payable (Exhibit 3). This presentation should include unpaid income taxes for prior tax years and estimated income taxes accrued on the financial statement date for the current tax year. The determination of the accrued income taxes should be based on the relationship of taxable income earned to total estimated taxable income for the year, net of any tax payments. To illustrate, assume that an estimated yearly tax liability of $30,000 is based on total expected taxable income of $75,000, and $45,000 has been earned by the financial statement date. The estimated current amount of the tax liability is calculated as follows:

$$\frac{\text{income earned to date}}{\text{estimated yearly taxable income}} \times \text{estimated yearly tax liability}$$

or:

$$\frac{\$45{,}000}{\$75{,}000} \times \$30{,}000 = \$18{,}000$$

Thus, $18,000 is the tax liability. If, however, tax payments of $15,000 had been paid by the financial statement date, only $3,000 would be presented as the tax liability.

Finally, since the presentation of personal financial statements focuses on the pro forma effect of liquidation, the assumption is made that the pro forma tax consequences of such liquidation should be shown. As a result, the SOP requires the disclosure of estimated income taxes on the difference between the current value of assets and estimated total amounts of liabilities, and their tax basis (Exhibit 3). This consistency on highlighting the liquidity function is very practical because under conditions of liquidation, tax liabilities must be satisfied before other debtors are paid. The Committee believes that a provision for such estimated income tax conveys relevant information relating to cash flows and the ability to meet obligations. To provide guidance in making the calculations, the SOP states that the assumptions and the basis for tax computation should depend on the facts, circumstances, tax laws and regulations, and assumptions that apply to the individual or individuals for whom the financial statements are prepared. The SOP requires the use of accompanying footnotes to disclose the methods and assumptions used in the tax computations.

EXHIBIT 3
Methods for Estimating Current Amounts of Liabilities

Item Classification	Recommended Valuation Methods
1. Payables and noncancellable commitments	Discounted amounts.
2. Income taxes payable	Unpaid income taxes for completed tax years and estimated taxes for elapsed portion of current tax year.
3. Estimated income taxes on the difference between net assets at current values and their applicable tax bases.	Use applicable income tax laws for the current reporting period.

Exhibit 4 illustrates how a worksheet can be used for determining the income tax provision on the excess of asset current values over their tax bases. The estimated income tax provision is determined to be $239,000 and is presented between the liabilities and net worth sections in the Statement of Financial Condition. An advantage of the worksheet is that it provides a systematic approach for determining the tax provision and facilitates the formulation of required footnote disclosures. The reader should note that a provision for estimated income taxes should also reflect the tax consequences that result from differences between estimated current amounts of liabilities and their tax basis. The example shown in Exhibit 4 assumes that there is no difference between the tax basis of liabilities and their estimated current amounts. If such consideration were necessary, appropriate calculations could easily be incorporated into the model worksheet.

Conclusion

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has recently completed the first step in reevaluating the accounting and reporting standards applicable to personal financial statements. As a result, in October 1982, Statement of Position 82-1 was issued which amends the accounting provision of the 1968 Audit Guide, "Audits of Personal Financial Statements." The major thrust of the SOP is the required basis of presenting financial statement elements. Estimated current values for assets and estimated current amounts of liabilities is the new basis of presentation. This departure from historical cost is predicated on the assumption that current values are more useful in light of the various ways personal financial statements are used.

The AICPA has completed the second and final step of the reevaluation project. The Institute has issued an audit guide entitled,"Personal Financial Statements — Compilation, Review and Audit." This document will provide guidance on the scope of work, the form of an audit report, and the review or compilation of personal financial statements in conformity with the accounting provisions of SOP 82-1. Because the SOP will have a significant impact on the accounting and

EXHIBIT 4

Model Worksheet for Computing Estimated Taxes on Excess of Asset Current Values Over Their Tax Bases

Description	(1) Estimated current values	(2) Tax bases	(3) Excess of (1) over (2)	(4) Effective income tax rates	(5) Amount of estimated income taxes (col. 4 x col. 3)	Assumptions used
Cash	$ 3,700	$ 3,700	—	—	—	No tax effect.
Bonus receivable	20,000	—	$ 20,000	50%	$ 10,000	Maximum tax rate.
Investments						
Marketable securities	160,500	56,400	104,100	36%	37,500	Weighted average of short-term and long-term capital gain rates based on composition of portfolio.
Stock Options	28,000	20,000	8,000	50%	4,000	Short-term capital gain rate.
Kenbruce Associates	48,000	24,000	24,000	38%	9,100	Weighted average of short-term and long-term capital gain rates.
Davekar Company, Inc.	550,000	119,500	430,500	20%	86,100	Long-term capital gain rate.
Vested interest in deferred profit sharing plan	111,400	—	111,400	50%	55,700	Maximum tax rate.
Remainder interest in testamentary trust	171,900	74,900	97,000	26%	25,600	Weighted average of short-term and long-term capital gain rates.
Cash value of life insurance	5,500	5,500	—	—	—	No tax effect.
Residence	190,000	190,000	—	—	—	No tax effect.
Personal effects	55,000	30,000	25,000	20%	5,000	Long-term capital gain rate.
Jewelry	40,000	10,000	30,000	20%	6,000	Long-term capital gain rate.
Totals	$1,384,000	$534,000	$850,000[1]			
Estimated income tax provision					$239,000[2]	

[1]The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.

[2]This amount should be presented in the Statement of Financial Condition between liabilities and net worth.

SOURCE: SOP 82-1, AICPA, October, 1982, p. 27.

reporting of personal financial affairs, it is imperative that accountants and auditors become aware of the new requirements and begin planning for an orderly, systematic transition under the newly established standards. Ω

NOTES

[1]Audit Guide, "Audits of Personal Financial Statements," AICPA, 1968.

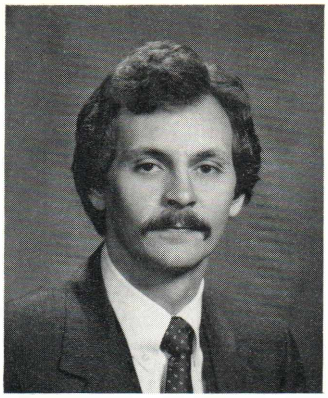
[2]Exposure Draft, "Proposed Accounting Section Personal Financial Statements Guide," AICPA, 1981.

[3]Statement of Position 82-1, "Accounting and Financial Reporting for Personal Financial Statements," AICPA, 1982.

[4]Audit Guide, "Audits of Personal Financial Statements," AICPA, 1968, p. 2.

[5]Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," FASB, 1978.

[6]SOP 82-1, p. 16, paragraph 32.



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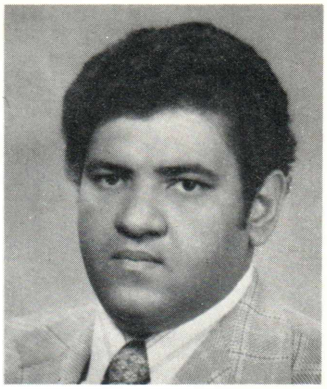

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The Increasing Number of Women Accountants is Significant

	Women in the Labor Force		Women Employed in Accounting		Men Employed in Accounting	
	Number	Percentage Compared to 1960	Number	Percentage Compared to 1960	Number	Percentage Compared to 1960
1960	21,874,000	100.0%	82,000	100.0%	414,000	100.0%
1970	29,667,000	135.6%	187,000	228.0%	526,000	127.1%
1980	41,283,000	188.7%	379,000	462.1%	668,000	161.4%

Employment numbers from *Statistical Abstract of the United States* (U.S. Government Printing Office, 1970, 1980).

Table provided courtesy of Rodger Trigg, Ph.D., CPA, and Associate Professor and Chairman of the Accounting Department at Columbus College, Columbus, Georgia.